Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-3584-98 and
TL-N-7043-99

NGraml

date: February 4, 2000

to: Chief, Examination Division, Houston District
Attn: Bud Schroeder, Case Manager, Groups 1101 & 1102,
Stop 4102 HOU

from: District Counsel, Houston District, Houston

---

subject: [redacted]
Taxable Year [redacted]
TIN: [redacted]
Statute of Limitations: [redacted]

This document may contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the Service, including the taxpayer involved, and its use within the Service should be limited to those with a need to review the document in relation to the subject matter or case discussed herein. This document is also tax information of the instant taxpayer which is subject to I.R.C. § 6103.

Attached is a response just received from our national office that reviews our advice to you of January 13, 2000, regarding the "bargain sale" issues. In the interest of time, I am sending you the response without a supplemental memo from us, because the national office has many factual questions which you need to be aware of prior to your IDR deadline at the end of this month.

In addition to sections 280G and 338(h)(10), our national office thinks there may be a section 482 issue, depending on further developed facts, and a possible section 304 redemption issue with respect to taxpayers other than [redacted]. Also, as we mentioned in our previous memo, there may be a constructive dividend issue to other taxpayers under section 301.

Please call me if you have questions, at 281-721-7358.

BERNARD B. NELSON
District Counsel

By:

NANCY GRAML
Attorney

Copy to: Ralph A. Edwards, Senior Team Coordinator
EB-1, CEP Group 1101, Stop 4101 HOU
Examination Division, Houston District

Attachments: as stated

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-3584-98 and
TL-N-7043-99

NGraml

date: January 13, 2000

to: Chief, Examination Division, Houston District
Attn: Bud Schroeder, Case Manager, Groups 1101 & 1102,
Stop 4102 HOU

from: District Counsel, Houston District, Houston

---

ubject: [redacted]
Taxable Year [redacted]
TIN: [redacted]
Statute of Limitations: [redacted]

You requested our assistance regarding the issues below for this C.E.P. case. We could find no published authority on point regarding the first issue; it appears to be novel. We understand your schedule dictates that final information document requests must be sent no later than the end of February 2000. Because of this we are forwarding a copy of this memorandum to our National Office for postreview, pursuant to CCDM (35)3(19)4. We plan to follow up with our National Office for their guidance and will make every effort to supplement this memorandum as time permits. The advice in this memorandum is subject to modification by the Assistant Chief Counsel (Field Service).

FIRST ISSUE

Whether the taxpayer's asset sale of its subsidiaries to a private corporation was below fair market value, and if so, whether the "bargain sale" was a disguised golden parachute payment to the private corporation's management, who were also the former managers of the taxpayer and its predecessor, pursuant to I.R.C. § 280G.

PRELIMINARY CONCLUSION REGARDING FIRST ISSUE

The private corporation apparently acquired the taxpayer's subsidiaries at book value. The known facts provide a reasonable basis to seek additional information, discussed in this memorandum, regarding whether the acquisition price was less than fair market value. If the acquisition was a "bargain sale," this fact typically applies to whether there was a constructive dividend to any purchaser-party that was a shareholder of the taxpayer-seller. The issue the Service presents, however, is novel.

Whether such a "bargain sale" can be a disguised "golden parachute" payment to the taxpayer's former key managers is a question of law that we are coordinating with the Office of Chief Counsel. This issue needs factual development that includes (1) whether there was an agreement between the taxpayer's predecessor, [redacted], and its management that granted the managers the option to acquire the subsidiaries at their book value in the event of a change of ownership; (2) whether there was an agreement that [redacted]'s successor, [redacted], the [redacted] percent owner of the taxpayer, would assume this "liability;" (3) whether there was an agreement that the taxpayer assumed this "liability;" and (4) whether there was an agreement between the purchasing corporation and the managers that would allow the managers to financially benefit from the purchasing corporation's acquisition of the subsidiaries at the "bargain" price. This memorandum discusses the additional factual information that the Service needs to develop.

SECOND ISSUE

Whether, as part of the purchase price of the subsidiaries, the private corporation-purchaser assumed certain liabilities of the taxpayer, and if so, whether the gross sales price reported by the taxpayer should be increased by these amounts pursuant to I.R.C. § 338(h)(10) and the regulations thereunder.

PRELIMINARY CONCLUSION REGARDING SECOND ISSUE

In accordance with the regulations under I.R.C.

§ 338(h)(10), the taxpayer is required to include the liabilities assumed by the purchasing corporation in its reported gross sales price. Whether the taxpayer did include these liabilities is a question of substantiation. The taxpayer provided ambiguous information to the Service, when compared to published information, regarding the subsidiaries' balance sheet at the time of their acquisition. This memorandum discusses this ambiguity and provides suggestions for seeking additional information from the taxpayer.

FACTS

Background. In [redacted], under [redacted], [redacted] was formed. During the next [redacted] years [redacted] acquired [redacted] properties, which it subsequently developed and explored, increasing its reserves and production. On [redacted] [redacted] purchased more than [redacted] percent of [redacted]'s shares, in a stock acquisition under I.R.C. § 361(a),[1] and created [redacted] [redacted], the taxpayer herein, as parent of the former [redacted]'s oil and gas operations, including [redacted] [redacted] had no parent corporation at the time it was acquired. [redacted] owned [redacted] percent of the shares of [redacted]; consequently, in [redacted] [redacted] filed a separate consolidated income tax return from [redacted]. From [redacted] through [redacted] [redacted] was the [redacted] percent shareholder of these [redacted] relevant subsidiaries (collectively, "the subsidiaries"):

[redacted]: proposed and managed working interest drilling funds for retirement investment plans

[redacted]: managed working interest drilling projects funded by [redacted]

[redacted]: a subsidiary of [redacted] which provided drilling project financing to outside exploration and drilling companies to be repaid through production payments

Acquisition. On [redacted] [redacted] sold the above [redacted] subsidiaries to [redacted] a private corporation formed by the management of [redacted] (the management) and an affiliate of a third party, [redacted].

---

[1] The [redacted] shares that [redacted] did not acquire were owned by [redacted]'s employees, and those employees exchanged their [redacted] shares for shares of new stock in [redacted] [redacted] and/or its subsidiaries.

All of the management of [redacted] were former managers of [redacted] (or its affiliates/subsidiaries). [redacted] provided the equity financing of [redacted] dollars and [redacted] shares of common stock were issued. We do not know whether the initial shareholders included the management of [redacted], but we believe that [redacted] was the initial majority shareholder who purchased these shares at $[redacted] per share (see page [redacted] of the Initial Public Offer (IPO) prospectus). [redacted] provided the debt financing for, we believe, [redacted] dollars.[2]

Taxpayer's Return. [redacted], in its consolidated tax return for the taxable year ending [redacted] reported the sale of the subsidiaries to [redacted], for net cash paid of [redacted] dollars (reported gross sales price) and a net loss of [redacted] dollars. [redacted] admitted to the Service that, in connection with the transaction, there were no appraisals of the subsidiaries' assets performed. [redacted] treated the transaction as a deemed asset sale under section 338(h)(10), rather than a sale of stock. [redacted] calculated its reported gross sales price as "net cash paid" as follows:

"Purchase Price"	$[redacted]
Less: "Purchase Price Adjustment"	
Less: "Severance"	
Net Cash Paid (gross sales price)	$ [redacted][3]

Sales Agreement and Explanation of Purchase Price. In the sales agreement between [redacted] and [redacted], the "purchase price adjustment" of [redacted] dollars consists of a "shareholder advance balance" which is the reconciliation of [redacted]'s advances to the subsidiaries and the amounts of repayments by the subsidiaries to [redacted]. Apparently, the [redacted] dollar amount is the net balance due from the

---

[2] The IPO prospectus states on page [redacted] that [redacted] was capitalized on [redacted] with the issuance of [redacted] shares of common stock for [redacted] dollars and borrowings of [redacted] dollars and [redacted] dollars under its "Revolving Credit Facility" and "[redacted] Company Credit Facility," respectively. Elsewhere, the prospectus reveals that "Revolving Credit Facility" debt was at [redacted] percent per annum and the "[redacted] Company Credit Facility" debt was at [redacted] percent per annum.

[3] [redacted]'s IPO prospectus, on the other hand, reported a purchase price for the subsidiaries of [redacted] dollars with an assumption of liabilities worth [redacted] dollars.

subsidiaries to [redacted] and was deducted from the purchase price paid [redacted] by [redacted]. The sales agreement, in paragraph [redacted], describes the "severance" amount (of [redacted] dollars) as an assumption by [redacted] of [redacted]'s liability under "[redacted]" and the "[redacted]" to pay certain employees of the subsidiaries the aggregate amount of [redacted] dollars, which was deducted from the purchase price.

Post-Acquisition Private Corporate Activity. In [redacted], [redacted] issued [redacted] of its shares to its management at $[redacted] per share, which [redacted] partially financed at [redacted] percent per annum. Also in [redacted] [redacted] granted stock options to its management and other employees in the respective stock option amounts of [redacted] and [redacted] (totaling [redacted] shares).[4] It is unknown whether any of these options were exercised.

Between [redacted] and the IPO, the Service believes there were no acquisitions to increase the value of [redacted], except [redacted] dollars in receivables to [redacted] for financing it provided (presumably to a third party) for [redacted] coastal drilling projects.

Initial Public Offering (IPO). On [redacted] in an initial public offering (IPO), [redacted] offered [redacted] shares at $[redacted] per share, which the Service believes were issued at that price. [redacted] offered (and presumably issued) [redacted] and [redacted] shares to [redacted] and the underwriters, respectively, for $[redacted] a share, at more than triple the price of the shares previously issued to the management. Total stock outstanding immediately after the [redacted] IPO was [redacted] shares, which excludes [redacted] shares reserved for issuance pursuant to outstanding options to key employees of [redacted]. At a value of $[redacted],[5] the total public share value of outstanding stock was approximately [redacted] dollars, compared to the taxpayer's [redacted] reported purchase price of [redacted] dollars. After the IPO, [redacted] owned [redacted] percent of the

---

4 Details of the stock option grant, i.e., the price per share and the time period of the grant, can be found in the IPO prospectus at the Service's designated page number [redacted]

5 The net price per share was $[redacted] after IPO issuing costs are deducted. The Service included the [redacted] shares for stock options, reserved for issuance, in its computation of a total market value of shares outstanding at [redacted] dollars.

outstanding shares,[6] according to the projection in the IPO prospectus.

Profit to Management. The IPO prospectus discloses that, at the IPO price of $[redacted] a share, investors will experience a dilution of $[redacted] in the net tangible book value per share (or a net book value per share of $[redacted]. The net book value per share will be further diluted upon the exercise of key employee stock options (previously stated). [redacted] projected (on page [redacted] of the IPO prospectus) the net proceeds from the IPO to be [redacted] dollars (excluding a contingent "over-allotment" option to the underwriters), of which all but approximately [redacted] dollars would be used to pay its outstanding debt. The [redacted] dollars would be used as working capital and as an investment in new income-producing assets for [redacted]. This would yield a net tangible book value of $[redacted] a share as a result of the IPO.

[redacted] and [redacted]'s management and employees, who purchased the stock at $[redacted] a share prior to the IPO, were prohibited by SEC rules from selling these shares for 180 days from the IPO. What the management ultimately realized from their ownership in [redacted], if relevant, can be determined by the price per share at the time they ultimately sold their shares times the number of shares sold. The total number of shares sold by management would depend on whether they exercised their stock options, which is unknown.

Determination of the IPO Price. [redacted], [redacted], [redacted], and the underwriters determined the IPO price by an analysis of the following factors: (1) market conditions for IPOs; (2) the history of and prospects for [redacted]'s business; (3) [redacted]'s "past and present operations;" (4) its past and present earnings, and current financial position; (5) an assessment of [redacted]'s management; (6) the market of securities of companies in businesses similar to those of [redacted]; and (7) the general condition of the securities markets and "other relevant factors."

Subsidiaries' Asset Value. [redacted]'s IPO prospectus

---

[6] We verified this by adding [redacted] percent of the initial shares issued ([redacted]) to the additional shares issued to [redacted] during the IPO ([redacted], divided by the total shares outstanding after the IPO ([redacted]), excluding shares reserved for management and employee stock options. This affirms our belief that [redacted] owned [redacted] percent of the shares of [redacted] immediately after acquisition of the subsidiaries.

provides that, in accordance with the SEC, it estimated its net proven reserves as of the end of [redacted] at [redacted] dollars, and estimated its [redacted] (believed to be the former assets of [redacted]) at [redacted] dollars. The appraisal report regarding the "proven reserve value" begins on the Service's page [redacted][7] of the IPO prospectus. The IPO prospectus also provides an independent auditors' report (on the Service's page number [redacted]) that shows [redacted]'s oil and natural gas properties valued at the "full cost method" for [redacted] dollars as of [redacted]. This amount is later referenced (on the Service's page [redacted]) as the "fair market value."

The IPO prospectus, on the Service's page [redacted], provides the Independent Auditors' Report that states [redacted] used the "purchase method" of accounting and booked the assets of the subsidiaries in its balance sheet, as of [redacted], "at their estimated fair market value" (in [redacted] of dollars) as follows:

Assets	
Accounts Receivable - Trade	$ [redacted]
[redacted] Program Notes Receivable	
Oil and Gas Properties	
Other Assets	
Total Assets	$
Liabilities:	
Accounts Payable	$ [redacted]
Long-Term Debt	
Total Liabilities	$
Net Asset Value (our computation)	$ [redacted]

The net asset value corresponds to [redacted]'s representation of the purchase price and matches the reserve value booked at the "cost method" for [redacted] dollars.

Post-IPO Acquisition. Between the time of the IPO in [redacted] and the [redacted] half of [redacted], [redacted] engaged in various sales and acquisitions until it was bought by [redacted], a third party, for [redacted] dollars.

---

7 The IPO prospectus provides one set of page numbers that appear in various locations on each page. The Service numbered its copy with a second set of page numbers at the bottom. We refer to the Service's page number when the page does not reflect any other number.

Service's Position Regarding First Issue. The Service questions whether [redacted]'s claimed loss from the [redacted] sale of the [redacted] subsidiaries was due to a sales price at below fair market value. The Service compares the [redacted] dollar sale price to that of the IPO six months later which resulted in [redacted]'s total outstanding stock at a public market value, according to its computation, of [redacted] dollars, with no material change in [redacted]'s net assets in the interim. Secondarily, the Service compares [redacted]'s sale price of [redacted] dollars to [redacted] one year later. The Service has no knowledge of any connection between [redacted] and the management, other than location. [redacted] is located in both [redacted] and [redacted], the same as [redacted], where the management was formerly employed. If the sale was below fair market value, the Service suggests the difference may be a disguised golden parachute payment to the management, which [redacted] could not otherwise deduct.

Additional facts relevant to the second issue will be discussed later.

LEGAL SYNOPSIS AND REQUEST FOR ADDITIONAL INFORMATION REGARDING THE FIRST ISSUE

Section 280G of the Internal Revenue Code provides the "golden parachute" provisions. Congress intended for this statute to discourage the use of golden parachute payments to senior executives of a company in the event of a corporate takeover. Agreements for handsome parachute payments between the target corporation and its executives tended to encourage the executives to favor a proposed takeover, regardless of whether the takeover would be in the best interests of the target corporation's shareholders. Such payments promised to the executives also decreased the amounts paid to the target corporation's shareholders; in other words, parachute agreements discouraged the arms length bargaining process when determining the acquisition price. For these reasons, Congress made such parachute payments nondeductible to the payor, and subject to an excise tax of 20 percent, in addition to the regular income tax, in the hands of the recipient. See Cline v. Commissioner, 34 F.3d 480 (7th Cir. 1994)(affirming Balch v. Commissioner, 100 T.C. 331 (1993)).

Section 280G provides that no deduction shall be allowed under chapter 1 for any excess parachute payment. A parachute payment is defined in section 280G(b)(2)(A) as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change (I) in ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation, and (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual that are contingent on the change equals or exceeds three times the base amount. I.R.C. § 280G

The "base amount" is the average of the individual's compensation for the previous five years, pursuant to section 280G(b)(3) and (d)(2). Section 280G(b)(4) defines an "excess parachute payment" to mean any parachute payment that exceeds the individual's base amount. To the extent the rules apply, once the golden parachute exceeds 300 percent of the executive's average annual compensation, the payor loses the deduction in excess of 100 percent of average annual compensation. The executive-recipient must pay a 20 percent excise tax on the amount the employer-payor may not deduct. See Cline v. Commissioner, 34 F.3d 480 (7th Cir. 1994)(affirming Balch v. Commissioner, 100 T.C. 331 (1993)).

Section 280G(c) defines a "disqualified individual" as an employee, independent contractor, or other person specified in regulations by the Secretary, who performs personal services for any corporation, and is an officer, shareholder, or highly-compensated individual. The term "highly-compensated individual" only includes an individual who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation. I.R.C. § 280G(c). The Service needs to know each applicable key executive's "base amount" and each executive's pay as a percentage to other employees' compensation in former [redacted], or if less than 1 percent, whether the key executive is among the highest paid 250 employees of the former [redacted].

A "change of ownership" occurs when a person or persons acting as a group acquires ownership of stock of the corporation, which, together with stock previously held by such person or group, possesses more than 50 percent of the total fair market value or total voting power of the stock of such corporation. Persons will be considered to be "acting as a group" if they are owners of an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. A "change of effective control of a corporation" is presumed to occur on the date that either (1) a person or persons acting as a group acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by the person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the corporation, or (2) a majority of members of the corporation's board of directors are replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or elections. This presumption may be rebutted by establishing that the acquisition or acquisitions of the corporation's stock, or the replacement of the majority of the members of the corporation's board of directors, do not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). In the absence of an event described in (1) and (2), above, a change in effective control of a corporation is presumed not to have occurred, which is rebuttable. Prop. Treas. Reg. § 1.280G-1, 54 Fed. Reg. 25879 (1989). Accordingly, [redacted] had a change of ownership when [redacted] acquired more than [redacted] percent of its voting stock; [redacted] did not have a change of ownership when it sold the subsidiaries, as more fully discussed below.

A "change in ownership of a substantial portion of a corporation's assets" occurs on the date that any one person, or more than one person acting as a group, acquires (or has acquired during a 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total fair market value equal to more than one-third of the total fair market value of all of the assets of the corporation immediately prior to the acquisition or acquisitions. For this purpose, a transfer of assets by the corporation is not treated as a change of ownership of the assets if the corporation transfers the assets to an entity in which immediately after the transfer, the shareholders of the corporation own a greater than 50 percent interest (by value of voting power). Prop. Treas. Reg. § 1.280G-1, 54 Fed. Reg. 25879 (1989).

Relevant to the change of ownership question, section 280G(d)(5) provides that, except as otherwise provided by the regulations, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) shall be treated as one corporation for purposes of section 280G. Section 1504(a) generally defines an "affiliated group" as one or more chains of corporations connected through stock ownership with a common parent corporation that owns at least 80 percent of the voting stock (and has a value equal to at least 80 percent of the total value of the stock) of such corporation(s). I.R.C. § 1504(a).

In applying the change of ownership rules regarding [redacted] we look to [redacted], the parent of the subsidiaries, not the subsidiaries themselves. [redacted] owned less than 80 percent of [redacted] and, therefore, it is not part of the same "affiliated group." It is the opinion of the Office of Chief Counsel that there was no change in stock ownership or voting power when the [redacted] subsidiaries were sold because there was no change of such in [redacted]. We can apply only the "substantial portion of the corporation's assets" test, and the Service confirms that the fair market value of the subsidiaries' assets was less than 30 percent of the asset value of [redacted]. We conclude there was no change of ownership with respect to the sale of the subsidiaries by [redacted] to [redacted].

If there was a golden parachute agreement, such an agreement would have been between [redacted] and the management. We request that you obtain a copy of any such agreement. We also suggest you obtain an agreement, if it exists, any agreement where [redacted]'s successor would assume the parachute payment liabilities, such as [redacted] and [redacted]. Whether there was such a liability resulting from the management's termination from [redacted]'s subsidiaries remains a question of fact, depending on the terms of any such agreements. In addition, if none of the managers were shareholders of [redacted] when it acquired the subsidiaries, we ask that you obtain any agreement, if it existed, between the management and [redacted] regarding what the management was supposed to gain from their alignment with [redacted] in the suspected "bargain" purchase.

Assuming there is a golden parachute liability originating with an agreement between [redacted] and the management, and assumed by either [redacted] or [redacted], and a side agreement with the management and [redacted], any transfer of property might be scrutinized as a payment and taken into account at its fair market value. I.R.C. § 280G(d)(3). We have requested coordination with the Office of Chief Counsel regarding how we would compute the value of the suspected golden parachute payments herein.

Accordingly, we request the following additional information regarding the golden parachute issue:

1. The names of "the management" of [redacted] that were formerly with [redacted] and [redacted] and their average compensation for the five years previous to the sales transaction.

2. Whether each manager was an officer, shareholder or "highly compensated individual" of [redacted] within the meaning of the statute summarized above.

3. Documents concerning all employment agreements between

the management and [redacted], [redacted] and [redacted], and [redacted] and [redacted] which would include employment contracts, contracts that assume employment liabilities, and Board of Directors' minutes that would have discussed any such agreements, including minutes of the Compensation Committees of the Board of Directors of [redacted] [redacted] [redacted] and [redacted].

4. Documents that explain the [redacted] dollar "severance" amount deducted by [redacted] from the purchase price.

5. Copy of "Securityholders Agreement," dated [redacted] between [redacted], [redacted] and [redacted]'s officers, as referenced on page [redacted] of the IPO prospectus.

6. Copy of the "Schedule 9.04" referenced by paragraph 9.04 of the sales agreement which specifies the employees and amounts of liability assumed by [redacted] regarding "severance."

7. Copy of the Amended and Restated [redacted] Stock Purchase and Option Plan for Key Employees of [redacted]," referenced by the IPO prospectus.

8. Copy of [redacted]'s Annual Report for [redacted].

9. Copy of the "[redacted] in connection with the acquisition" between [redacted] and [redacted], as stated in the IPO prospectus page [redacted] (or the Service's page number [redacted].

10. The "fair market value" of the assets of the [redacted] subsidiaries sold to [redacted] in [redacted]. This aspect is discussed more fully below.

It is well established that fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy and sell, and both being informed of the material considerations. Of course, the fair market value of property at a particular time is a question of fact to be determined from all of the circumstances connected with the transaction, and there is no single formula universally applicable in determining such value. Fair market value means that there are sufficient available persons able to buy to assure a fair and reasonable price in light of the circumstances affecting value. Dellinger v. Commissioner, 32 T.C. 1178, 1184-85 (1959). Ordinarily, the price at which the same or similar property has changed hands is persuasive evidence of fair market value. Where the parties to the sale have dealt with each other at arm's length and the sale is within a reasonably close period of time to the valuation date, the price agreed upon is considered to have accurately reflected conditions in the market. Palmer v. Commissioner, 62 T.C. 684, 696 (1974), aff'd, 523 f.2d 1308 (8th Cir. 1975), acq., 1978-2 C.B. 2, non acq., 1978-2 C.B. 4.

Two facts raise a serious question regarding whether [redacted]'s sale of the subsidiaries was at fair market value. First, [redacted] performed no valuation of the assets in connection with the acquisition and, second, the SEC required reserve valuation of the subsidiaries was [redacted] dollars versus their book value at [redacted] dollars as of the end of [redacted]. We question why [redacted] would sell the subsidiaries at book value without more. We believe the Service is justified in developing additional facts to determine the fair market value of the subsidiaries' assets as of [redacted] under the query of paragraph [redacted]:

(a) Documents of [redacted]'s Board of Directors' minutes relating to the sales transactions and all other documents that would support paragraph 2.03 of the sales agreement stating that the transaction had been "duly authorized by all necessary corporate action;"[8]

(b) [redacted]'s reason why it sold the subsidiaries at the time;

(c) Whether other shareholders of [redacted] were given an opportunity to acquire the subsidiaries;

(d) Copies of the "commitment letters" from [redacted] and [redacted], referenced by paragraph 3.03 of the sales agreement, including, if available, all documents relied upon by both entities to support their "commitment letters," including any valuation report of the subsidiaries' net worth that may have been prepared by these entities around the time of the transaction;

(e) Whether third parties had the opportunity to bid or purchase the subsidiaries at the time, including an explanation of whether and how an offer to sell was publicly promoted;

8

We are surprised that [redacted] claims there was no appraisal performed with respect to the [redacted] acquisition because, at a minimum, [redacted]'s directors would want to justify the sales price to its shareholders.

(f) A reconciliation of the reserve valuation amounts under the facts provided in pages [redacted] and [redacted];

(g) Whether there were any [redacted] shareholder suits against [redacted]'s officers or directors for breach of fiduciary duty concerning the sales price;

(h) Market price of the type of oil and gas produced by [redacted] in [redacted] versus the market price of the same during the time of the IPO (end of [redacted]);

(i) Common stock price of a public corporation similar in size and type of assets to [redacted] in [redacted] versus its stock price of the same during the time of the IPO;

(j) Whether there were any other offers to buy the subsidiaries at the time and, if so, the terms of the offers;

(k) Copies of the "[redacted] Consents" and documents that show the solicitation by [redacted] for such consents, referenced by section 1.05 of the sales agreement which required certain "investors" of [redacted] to consent to the sales transaction; and

(l) Written analyses prepared by [redacted], [redacted] [redacted] and/or the underwriters that discuss how [redacted]'s IPO share price was determined in accordance with the factors set forth in the "Underwriting" section of the IPO prospectus (or as set forth in the Facts section of this memorandum.

We note that the "bargain sale" issue in the corporate context is typically developed as an issue of whether certain shareholders received constructive dividends as income. This issue could apply to our facts if either [redacted] or any of the managers of [redacted] were former shareholders of [redacted]. If so, the Service may want to examine these taxpayers' liabilities so long as the statute of limitations for assessment is still open.

LEGAL SYNOPSIS REGARDING THE SECOND ISSUE

Because both [redacted] and [redacted] made an election under section 338 of the Internal Revenue Code, then, in the case of this qualified stock purchase, the target corporation, i.e., the subsidiaries herein, (1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and (2) shall be treated as a new corporation which purchased all of the assets referred to in (1) as of the beginning of the day after the acquisition date. I.R.C. § 338(a). No gain or loss will be recognized on stock sold or exchanged in the transaction by [redacted] the selling consolidated group. I.R.C. § 338(h)(10)(A).

Treas. Reg. § 1.338(h)(10)-1(e)and (f) dictate certain consequences of a section 338(h)(10) election like the [redacted] transaction herein. The old target[9] ([redacted]) recognizes gain or loss as if, while the old target was a member of the selling consolidated group, it sold all of its assets in a single transaction at the close of the acquisition date (but before the deemed liquidation). The old target's gain or loss is determined by paragraph (f). Treas. Reg. § 1.338(h)(10)-1(e). Paragraph (f) of the regulation generally requires that the price at which each asset of the old target is deemed to have been sold is calculated in part by determining the modified "ADSP (MADSP)" of deemed sales price. The deemed sales price is the sum of the grossed up basis of the purchasing corporation's recently purchased target stock, the new target corporation's <u>liabilities</u>, and "other relevant items." Treas. Reg. § 1.338(h)(10)-1(f)(emphasis ours). Liabilities taken into account are the liabilities of the new target (including the liabilities to which the target's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of the old target nor liabilities to which the old target's assets were subject). Treas. Reg. § 1.338(b)-1(f).

The Service questions whether [redacted] properly included in its deemed sales price the subsidiaries' liabilities in the hands of [redacted]. In other words, what liabilities did [redacted] assume when it purchased the subsidiaries? This is a factual issue which needs to be developed.

[redacted] has not provided the Service a calculation of whether the purchase price of [redacted] dollars includes liabilities assumed by [redacted], other than what may be two items of liabilities: the [redacted] dollar amount which is the net balance due from the subsidiaries to [redacted] and was deducted from the purchase price, and the "severance" amount of [redacted] dollars which appears to be an assumed severance liability to management. <u>We suggest that you ask [redacted] why they think these two amounts are not liabilities assumed under the section 338 regulations and should not be included in the reported purchase price</u>.

---

[9] The "old target" refers to the target corporation for periods ending on or before the close of the target's acquisition date; the "new target" refers to the target for subsequent periods. Treas. Reg. § 1.338(h)(10)-1(b)

Next, we are surprised that the sales agreement does not specify whether other liabilities of the subsidiaries were assumed by [redacted] and, if so, which ones. The subsidiaries had liabilities other than the two above-mentioned amounts. Who paid them? The facts are ambiguous and [redacted] needs to provide detailed substantiation to clarify them.

In its IPO prospectus, [redacted] represents that it paid a purchase price of [redacted] dollars and assumed liabilities of [redacted] dollars (including the assumption of an [redacted] dollar note which a creditor exchanged for stock). In the audited statements of the IPO prospectus, on the Service's numbered page [redacted], liabilities of the subsidiaries assumed by [redacted] as of [redacted] are shown as follows (in [redacted] of dollars):

Accounts payable	$[redacted]
Long-term debt	[redacted]
Total liabilities	$[redacted]

[redacted], on the other hand, filed a Form 8023 with its [redacted] return which reported that the consideration paid by [redacted] included the liabilities of the [redacted] subsidiaries, totaling [redacted] dollars.

The Service believes the gross sales price of [redacted] dollars did not include the [redacted] dollars in old target liabilities assumed, and that the deemed purchase price should be adjusted for this amount; whereas, [redacted]'s return says the purchase price did include these liabilities. Also, the Service believes the deemed purchase price should be adjusted for the amount of the "severance payments" of [redacted] dollars. We believe these figures should be clarified regarding what was and was not included.

If you have any questions or additional information, please do not hesitate to call the undersigned attorney at 281-721-7358.

BERNARD B. NELSON
District Counsel

By:
NANCY GRAML
Attorney

Copy to: Robert B. Misner, Assistant Branch Chief
CC: EBEO: Br 4, Rm. 5203
Office of Assistant Chief Counsel
(Employee Benefits & Exempt Organizations)
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Office of Assistant Chief Counsel (Field Service)
CC:DOM:FS, Rm. 4050
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Ralph A. Edwards, Senior Team Coordinator
EB-1, CEP Group 1101, Stop 4101 HOU
Examination Division, Houston District